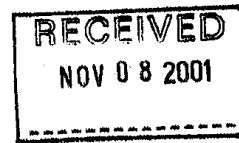




DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

SMALL BUSINESS/SELF-EMPLOYED DIVISION

NOV 8 2001



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *for* Joseph G. Kehoe *Richard J. Morgante*  
Commissioner, Small Business/Self-Employed

SUBJECT: Treasury Inspector General for Tax Administration  
(TIGTA) Draft Report – Opportunities Exist to More Effectively  
Process Personal Service Corporation Income Tax Returns  
(Audit No. 200030035)

We are concerned that we did not process personal service corporation tax returns correctly, and with the findings in your report we believe implementing your corrective actions will improve our processing of these returns. However, several of your corrective actions require significant systems changes and we cannot fully implement your recommendations before January 1, 2004.

If you have any questions about our response, please contact John A. Ressler, Director, Customer Account Services, SB/SE Division, at (859) 669-5557.

**IDENTITY OF RECOMMENDATION/FINDING #1**

The Directors of Customer Account Services and Compliance, Small Business/Self-Employed (SB/SE) Division, should coordinate to implement a process to identify taxpayers that are likely personal service corporations but did not file as such. For example, the IRS should identify returns by specific principal business activity codes related to personal service industries that had taxable income but calculated their tax at a rate other than 35 percent. The IRS should issue educational notices to these taxpayers regarding their classification as personal service corporations and suggest they file amended returns if that situation is properly applicable.

**ASSESSMENT OF CAUSE:**

The IRS currently does not have a process to identify and correctly process personal service corporation returns if taxpayers do not indicate that they are a personal service corporation.

**CORRECTIVE ACTION:**

**CORRECTIVE ACTION:**

The Customer Account Services area of SB/SE will implement a systemic enhancement to identify potential personal service corporations that had taxable income but calculated their tax at a rate other than 35 percent. Using Principal Business Activity codes, we will identify potential personal service corporations and issue educational notices will be issued advising them of their potential classification.

Implementing this action will require us to prepare a Request for Information Services (RIS) and develop a new notice. Fully implementing this recommendation depends on the RIS prioritization process and we cannot accomplish it before January 1, 2004.

**IMPLEMENTATION DATE:**

January 1, 2004

**RESPONSIBLE OFFICIAL:**

John A. Ressler, Director, Customer Account Services, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**

Policies, Procedure and Guidance, BMF Submission Processing will advise the Director, CAS of any delay change or problem with the following implementation schedule:

July 31, 2002 – Preparation of a Placeholder RIS for programming to generate the proposed notice.

November 31, 2002 – Preparation of Final RIS to generate the proposed notice.

January 1, 2004 – Implementation of the RIS.

**IDENTITY OF RECOMMENDATION/FINDING #2**

Identify, based on a predetermined level of potential tax revenue, and work higher dollar cases when taxpayers do not respond to the educational notices or file amended returns.

**ASSESSMENT OF CAUSE:**

The IRS currently does not have a process to identify and correctly process personal service corporation returns if taxpayers do not indicate that they are a personal service corporation.

**CORRECTIVE ACTION:**

Compliance Policy will develop a process to identify and correctly process personal service corporation returns. Centralized Workload Selection and Delivery will provide the initial analysis to identify taxpayers that have personal service corporations and get Compliance Improvement Project (CIP) approval for any resulting examinations. We will send letters to taxpayers to request self-correction. When taxpayers do not respond to our letters or they do not file amended returns, we will conduct examinations.

**IMPLEMENTATION DATE:**

September 30, 2002

**RESPONSIBLE OFFICIAL:**

Sharon M. Oliver, Director, Compliance, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**

The Deputy Director, Compliance Policy will advise the Director, Compliance of any delay, change, or problem with implementing this recommendation.

**IDENTIFICATION OF RECOMMENDATION/FINDING #3**

The Director, Tax Forms and Publications, Wage and Investment Division, should make changes related to the personal service corporation check boxes on Form 1120 and 1120A to stress to taxpayers the importance of properly checking their personal service corporation status. Instructions and/or descriptions on the form should stress the purpose for each box and tax impact of the box related to the 35 percent flat tax rate. Some indication should be made to emphasize that the box on the tax schedule should be checked, if applicable, **even if there is no taxable income.**

**ASSESSMENT OF CAUSE:**

A review of 153 cases indicated that checkboxes were checked incorrectly and found that both taxpayers and the IRS had made errors completing or processing the tax returns. In 91 cases, taxpayers met requirements and should have checked both boxes but did not, and in 22 cases, taxpayers did not appear to meet the personal service corporation criteria and should not have checked either box, but did. In 40 cases, taxpayers appear to have made the correct entries on the tax returns. On page one of Form 1120, there are three checkboxes for the taxpayer to check, including one for personal service corporations as defined in Temporary Regulations section 1.441.4T. By checking the personal service corporation box here, the taxpayer is subject to a calendar year filing requirement. There is also a checkbox on Form 1120A for this purpose. Another checkbox in the tax computation section of the Forms 1120 and 1120A should be checked when a "qualified" personal service corporation is subject to the 35 percent flat tax rate rather than the graduated tax rates for corporations. Space is limited for explanations on the forms but the instructions define the distinct purposes for each checkbox. Also, there are situations where the taxpayer should only check one of the personal service corporation checkboxes since the requirements for each checkbox are different.

**CORRECTIVE ACTIONS:**

We will revise the checkbox area on Form 1120 to highlight the instruction to check one of the three boxes. We will also revise the instructions for Forms 1120 and 1120A to advise the taxpayer to check the box if they are a qualified personal service corporation even if they have no taxable income.

**IMPLEMENTATION DATE:**

November 30, 2001

**RESPONSIBLE OFFICIAL:**

Carolyn A. Tavenner, Director, Media and Publications  
Director, Customer Assistance, Relationships and Education, Wage and Investment  
Division

**CORRECTIVE ACTION MONITORING PLAN:**

We will begin printing the 2001 Form 1120 in November 2001. We have made the changes related to this recommendation. The analyst for the Form 1120 assigned to the Director, Media and Publications will ensure the changes are in the final version of the Form 1120.

**IDENTIFICATION OF RECOMMENDATION/FINDING #4**

The Director, Customer Accounts Services, SB/SE Division, should stress the importance of following existing processing instructions for smaller volume business return programs during training that is being conducted as the IRS consolidates the processing of business returns to two centers. This training should emphasize processing procedures and instructions for personal service corporation returns and the importance of the indicators and the impact they have on the processing of returns.

**ASSESSMENT OF CAUSE:**

Of the 153 cases sampled for this audit, 49 returns were improperly processed by IRS employees. IRS failed to either identify the return as a personal service corporation or to input the proper codes to record the identification. The specific reasons for these errors cannot be determined. The items may be overlooked because the personal service corporation issues only apply to a small percentage of the total Form 1120 returns that are processed.

**CORRECTIVE ACTIONS:**

We are currently developing training material with SB/SE analyst for the Processing Year 2002 to ensure emphasis is placed on the processing of personal service corporation returns. SB/SE analysts will visit the field to observe the training classes at Submission Processing Centers.

**IMPLEMENTATION DATE:**

March 31, 2002

**RESPONSIBLE OFFICIAL:**

John A. Ressler, Director, Customer Account Services, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**

The Chief, BMF Policies Procedures and Guidance will advise the Director, CAS of the effectiveness of training material and recommend changes to the training material.

**IDENTIFICATION OF RECOMMENDATION/FINDING #5**

The Director, Customer Account Services, SB/SE Division, should revise computer programming to accept taxpayers' tax computation when they file using the 35 percent flat rate. This would mirror the intended Error Resolution results and eliminate the risks of human error.

**ASSESSMENT OF CAUSE:**

When a return is processed without recordation of the personal service corporation status, IRS computer systems do not recognize that the 35 percent flat rate of tax should be assessed. The return is routed to an Error Resolution function for correction of the tax. The Error Resolution area does not always recognize the personal service corporation status, and an incorrect rate of tax is allowed. This results in a loss of revenue to the government.

**CORRECTIVE ACTIONS:**

The Customer Account Services area of SB/SE will prepare a RIS to allow the computer to accept a flat tax rate of 35 percent when this rate is used on the return. Implementing this action is depends on the RIS prioritization process, and we cannot accomplish it before January 1, 2004.

**IMPLEMENTATION DATE:**

January 1, 2004

**RESPONSIBLE OFFICIAL:**

John A. Ressler, Director, Customer Account Services, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:**

The Director, Customer Account Services, SB/SE Division will follow-up with the appropriate staff members to ensure that the following target dates are met:

July 31, 2002 – Preparation of a Placeholder RIS.

November 31, 2002 – Preparation of Final RIS.

January 1, 2004 – Implementation of the RIS.